

TEACHERS' RETIREMENT BOARD  
INVESTMENT COMMITTEE

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SUBJECT: Results of the 2001/2002 Investment Branch  
Objectives

ITEM NUMBER: 17

ATTACHMENTS: 1

ACTION: \_\_\_\_\_

DATE OF MEETING: July 10, 2002

INFORMATION: X

PRESENTER: Christopher J. Ailman

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Executive Summary

To close out the fiscal year, Attachment 1 is a review and results of 2001/2002 investment objectives and work-plan.

Discussion

Staff worked very hard to complete virtually all the objectives set by the Committee. This was evidenced by the Investment Committee agenda and meetings being very full and robust. Overall, staff is pleased to report, 20 of the 22 separate items were completed or commenced in the past year. Staff is also pleased to note that several items that were carried over from the prior year and in some cases over the past two fiscal years were completed. Two of the current year objectives will be completed or commenced at the July meeting. Prior Committee practice considered an item completed once it had been commenced since the ultimate conclusion could not be forecasted. Under that description, the foreign currency policy is considered completed even though it will be concluded in the fall semester. Only two items remained outstanding and will be carried over to the next fiscal year objectives.

The overall investment environment, in the past fiscal year, was very disappointing with a prolonged economic slowdown, and the tragedy of September 11<sup>th</sup>. It is anticipated that the overall portfolio will incur a second straight year of a negative return. Try as staff might, we could not change the capital markets. However, there were several small victories that were within staff control. These bright spots in a gloomy year are highlighted below.

Asset Allocation Re-balancing: After the terror of September 11, the senior investment staff talked to the major U.S. newspapers and the London Financial Times to reassure investors and clearly state our confidence in the U.S. financial markets. When the markets opened after the tragedy, staff recognized intra-day that the portfolio was below the policy exposure to U.S. equities. After a quick meeting of the senior investment staff and with the concurrence of the CEO and general consultant, staff took immediate action to maintain the allocation. In a decisive action, staff invested \$2.5 billion from the cash and fixed income portfolios into U.S. stocks during the September and October decline, including a large sum right at the September lows.

**Securities Lending:** Due to the restructuring of the securities lending program and the decline in interest rates, securities lending income rose 74% to \$92.8 million, resulting in an extra \$39.5 million to the Fund.

**Foreign Currency Repatriation:** Staff worked with the Controller's Office to remove a requirement to repatriate the System's foreign currency resulting in a saving of approximately \$4 million per year.

**Foreign Currency Hedging:** Through May 31, 2002, staff's currency hedge of the Japanese yen earned an extra \$71.6 million during the fiscal year.

**Non-U.S. Index:** Staff proactively recommended an early transition to the MSCI provisional index which netted the Fund about \$20 million in higher passive index returns through May 31, 2002.

**Asset Allocation Study:** Staff and the Committee completed a lengthy asset allocation review that included a survey and realignment of the Committee's investment objective. The study also marked the first time staff developed a set of recommended capital market assumptions. Upon adoption of the increased allocations to the private market asset classes, staff developed a four-year implementation plan.

In many areas staff worked diligently to improve operations and prepare the Fund to rebound as the markets improve. These projects include:

**Real Estate:** Starting in mid 2000/2001 fiscal years, the Real Estate staff undertook a 360-degree peer review with respect to the CalSTRS reputation and image within the real estate industry. This study has lead to re-branding the real estate image to one that is seen as large and slow to one that is large yet nimble sophisticated investors in the marketplace. Major steps have included the addition of several more independent fiduciaries and implementing a streamlined approval process for joint ventures and large transactions. In addition, the Fund completed one of its first joint venture investments in real estate.

**Private Equity:** To improve the management tools and increase self sufficiency for the private equity portfolio, staff reviewed and selected a portfolio reporting system called Private Edge by State Street Bank. Over the past year staff worked closely with Private Edge to load and reconcile the CalSTRS private equity portfolio and history. For the first time since the inception of investments in 1989, the Fund has its own database on the portfolio.

**Fixed Income:** With the CIO approval the Director of Fixed Income reorganized the unit to improve to expand discreet teams for the various sectors within the portfolio. The fixed income team now has corporate, government, and mortgage sub-groups, each with a portfolio manager and several analysts. The new staffing structure matches that of other large external fixed income investment organizations. With the addition of new positions, the Director has bolstered the research and credit analysis work in each group.

**Taskforce Work Teams:** Last year also marked the first large use of taskforce work teams within the Investment Branch. These teams were comprised of members from several asset class groups. The use of these work teams has helped reduce the so-called “silo effect” of the self-contained asset classes. These teams also empowered several levels of investment staff to provide input, exercise judgment, and generate recommendations on very major issues of the Fund. Lastly these teams have enhanced the leadership and management ability of the senior staff.

**Leadership Training:** The top three levels of the Investment Branch, ten people in all, have embarked on an 8-month leadership course that will eventually cover 11 full days. This course, taught by CalSTRS own Quality Training & Support staff, is based upon *The Leadership Challenge* by Kouzes & Posner. While just half way through the course, it has already pushed staff beyond its comfort zone and encouraged a fresh new look at leadership rather than management. While this will not show a near term profit, this endeavor should create a long-term gain to the Fund.

### Conclusion

While this was a very difficult and trying year for the financial markets, the Fund, the Board, and the staff, the Investment Branch has worked diligently to complete the numerous objectives set forth by the Committee. With the asset allocation study, the two benchmark changes, and the staff improvements, last year was a landmark year in the history of the CalSTRS portfolio. The senior investment staff believes the portfolio and structure are poised to capture the eventual rebound in the financial markets.

2001 – 2002 INVESTMENT BRANCH OBJECTIVES RESULTS

| <b>DIVISION</b>         | <b>DESCRIPTION</b>  | <b>STATUS</b>  |
|-------------------------|---|--|
| ALTERNATIVE INVESTMENTS | Explore the feasibility and potential benefits of private equity investments in under served urban and rural communities.   | <b>Completed</b> <input checked="" type="checkbox"/> |
|                         | Develop an implementation plan for a New and Next Generation Manager Program.   | <b>Completed</b> <input checked="" type="checkbox"/> |
|                         |   |  |
| CREDIT ENHANCEMENT      | Present an Annual Report on the Credit Enhancement Program including the types and volume of transactions in municipal finance, industrial development, and housing finance projects. | <b>Completed</b> <input checked="" type="checkbox"/> |
|                         |   |  |
| EXTERNAL EQUITY         | In conjunction with Fixed Income review and recommend a formal currency hedging policy to the Committee   | <b>Commenced, to be completed</b>                    |
|                         | In conjunction with Internal Equity, review the U.S. Equity benchmark and passive index management structure. Present recommendation to Committee.                                    | <b>Completed</b> <input checked="" type="checkbox"/> |
|                         | Present a Semi-annual report rating the investment managers.  | <b>Completed</b> <input checked="" type="checkbox"/> |
|                         | Explore, evaluate, and present an analysis regarding the selection of emerging market countries for investment.   | Continued to the fall '02 semester                   |
|                         |   |  |
| CORPORATE GOVERNANCE    | Will be determined at a future Subcommittee on Corporate Governance meeting   | <b>Completed</b> <input checked="" type="checkbox"/> |
|                         |   |  |
| INTERNAL EQUITY         | Present an annual report to the Investment Committee that reviews the development of the Cash Equitization program.   | <b>Completed</b> <input checked="" type="checkbox"/> |
|                         | In conjunction with External Equity, review the U.S. Equity benchmark and passive index management structure. Present recommendation to Committee.                                    | <b>Completed</b> <input checked="" type="checkbox"/> |

2001 – 2002 INVESTMENT BRANCH OBJECTIVES RESULTS

| <b>DIVISION</b>           | <b>DESCRIPTION</b>  | <b>STATUS</b>  |
|---------------------------|---|--|
| FIXED INCOME<br>LONG TERM | Select, complete contract negotiations and fund High Yield Bond managers.   | <b>Completed</b> <input checked="" type="checkbox"/> |
|                           | In conjunction with External Equity review and recommend a formal currency hedging Policy to the Committee  | <b>Commenced, to be completed</b>                    |
|                           | Explore the universe of Fixed Income benchmarks. Study, evaluate, and recommend the most suitable benchmark for the program.                                    | <b>Completed</b> <input checked="" type="checkbox"/> |
| HOME<br>LOAN              | Present an annual report on the Home Loan Program.  | <b>Completed</b> <input checked="" type="checkbox"/> |
|                           |   |  |
| INVESTMENT<br>OPERATIONS  | Review and recommend changes to the current repatriation of foreign currency requirements.  | <b>Completed</b> <input checked="" type="checkbox"/> |
|                           |   |  |
| REAL<br>ESTATE            | Implement plan for urban real estate investments.   | <b>Completed</b> <input checked="" type="checkbox"/> |
|                           | Study and report on Independent Contractor policies for building operations.  | <b>Completed</b> <input checked="" type="checkbox"/> |
|                           |   |  |
| SECURITIES<br>LENDING     | Present an Annual Report on the program   | <b>Completed</b> <input checked="" type="checkbox"/> |
|                           |   |  |
| SOFT<br>DOLLAR            | Present a financial statement report to the Investment Committee as part of the Semi-annual Budget report.  | Not completed, continued to 2002-'03                 |
|                           |   |  |
| GENERAL                   | Complete an asset allocation review as required by the Investment Management Plan.  | <b>Completed</b> <input checked="" type="checkbox"/> |
|                           | Report on the California real estate purchases that satisfy the legislative target to invest 25% of new cash flow.  | <b>Completed</b> <input checked="" type="checkbox"/> |
|                           | Present a Semi-annual report on California investments in rural and urban areas.  | <b>Completed</b> <input checked="" type="checkbox"/> |
|                           | Present a thorough review of the latest risk management practices and recommend a risk management policy.   | <b>Completed</b> <input checked="" type="checkbox"/> |
|                           | Revise the Investment Management Plan to reflect the modifications (if any) in the strategic asset allocation, investment objectives, and investment structure. | <b>Completed</b><br>@ the July meeting               |